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No. 89-697

In the Supreme Court of the United States

OCTOBER TERM, 1989

DOWNRIVER COMMUNITY FEDERAL CREDIT UNION, ET AL., PETITIONERS

v.

PENN SQUARE BANK, THROUGH ITS RECEIVER, FEDERAL DEPOSIT INSURANCE CORPORATION

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE TENTH CIRCUIT

BRIEF FOR THE UNITED STATES IN OPPOSITION

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QUESTION PRESENTED

Whether the ratable distribution requirement of the National Bank Act precludes the establishment of a constructive trust on behalf of an individual creditor of a failed national bank in the absence of a showing that the bank's fraud caused a particular harm to the creditor not shared by substantially all other creditors and that granting relief to the creditor would not disrupt the orderly administration of the receivership estate.

TABLE OF CONTENTS

	Page
Opinions below	1
Jurisdiction	1
Statement	2
Argument	7
Conclusion	12

TABLE OF AUTHORITIES

Cases:

American Surety Co. v. *Bethlehem Nat'l Bank*, 314 U.S. 314 (1941)	8
Bank of Marin v. *England*, 385 U.S. 99 (1966)	8
Beacon Mfg. Co. v. *Hood*, 204 N.C. 349, 168 S.E. 523 (1933)	6
Davis v. *Elmira Sav. Bank*, 161 U.S. 275 (1896)	8
FDIC v. *Braemoor Associates*, 686 F.2d 550 (7th Cir. 1982), cert. denied, 461 U.S. 927 (1983)	11
FDIC v. *Palermo*, 815 F.2d 1329 (10th Cir. 1987)	6
Fiman v. *South Dakota*, 29 F.2d 776 (8th Cir. 1928), cert. denied, 279 U.S. 841 (1929)	10
First Nat'l Bank v. *Selden*, 120 F. 212 (7th Cir. 1903)	5, 8
Hibernia Nat'l Bank v. *FDIC*, 733 F.2d 1403 (10th Cir. 1984)	6
Jennings v. *United States Fidelity & Guar. Co.*, 294 U.S. 216 (1935)	5
National Bank v. *Colby*, 88 U.S. (21 Wall.) 609 (1875)	9
Reno Nat'l Bank v. *Seaborn*, 99 F.2d 482 (9th Cir. 1938)	9, 10

Statutes:

12 U.S.C. 91	4
12 U.S.C. 194	3, 4, 8
12 U.S.C. 1819	5

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OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 1a-21a) is reported at 879 F.2d 754. The order and judgment of the district court (Pet. App. 22a-45a) are unreported.

JURISDICTION

The judgment of the court of appeals was entered on July 3, 1989. A petition for rehearing was denied on September 5, 1989 (Pet. App. 49a-50a). The petition for a writ of certiorari was filed on October 31, 1989. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATEMENT

1. Petitioner Downriver Community Federal Credit Union held about $4 million in certificates of deposit from Penn Square Bank and petitioner Wood Products Credit Union held about $500,000 in the Bank's certificates of deposit on July 5, 1982, when the Bank was declared insolvent by the Comptroller of the Currency and ordered closed. The Federal Deposit Insurance Corporation (FDIC) was appointed receiver of the Bank. After being paid $100,000 each, the amount of their insured deposits, Downriver and Wood Products applied for and were issued Penn Square Bank receiver certificates for the amount of their uninsured deposits. Each has received more than half of its uninsured funds. Pet. App. 3a-4a.

Petitioners sued the FDIC as receiver for Penn Square Bank in the United States District Court for the Western District of Oklahoma, seeking to recover all of their uninsured funds. They claimed that Penn Square Bank held those funds in constructive trust for their benefit because it had induced their deposits by issuing financial statements that materially misstated the Bank's financial condition. Pet. App. 3a-4a. The cases were consolidated for trial. In the liability phase, Downriver tried its fraud claim to a jury and Wood Products tried its claim to the court. Both triers of fact returned verdicts in favor of petitioners, finding that Penn Square Bank's December 31, 1981, and March 31, 1982, financial statements contained material misrepresentations; that those representations were relied upon by petitioners; and that the Bank's management either knew that the financial statements contained false or misleading information or recklessly made those representations

knowing that there were no reasonable grounds for believing them to be true. *Id.* at 4a.

The district court then addressed the remedial question—whether a constructive trust could be imposed on the assets held by the receiver for the benefit of petitioners. The court first held that Oklahoma law, rather than federal law, should be applied in deciding whether to impose a constructive trust. Pet. App. 34a. It further held that petitioners had satisfied the prerequisites for the imposition of a constructive trust under Oklahoma law. Specifically, it found that Penn Square Bank had obtained their deposits by fraud; that the deposits had augmented Penn Square Bank's assets; and that the deposits could be traced into assets held by the receiver. *Id.* at 35a-36a. The court also determined that the constructive trusts vested under Oklahoma law at the time of the original deposits, and then concluded that petitioners' funds were not subject to the ratable distribution requirements of the National Bank Act. The district court acknowledged that 12 U.S.C. 194 "requires ratable distribution among holders of receivers certificates," but the court thought that ratable distribution was not required in the case of "property that does not rightfully belong to the bank." Pet. App. 36a.

Although the district court imposed a constructive trust on the assets held by the receiver to the extent of the principal amount of the deposits and the interest accrued to the date Penn Square Bank was declared insolvent, the court denied petitioners' claims for post-insolvency, prejudgment interest. It held that "the controlling law on the issue of prejudgment interest is federal law because federal law applies *to any post-insolvency rights of* [*the*] *plaintiffs.*" Pet. App. 38a (emphasis added). The court

concluded that interest accruing on a claim after insolvency cannot be paid unless the assets are sufficient to pay all claims in full, since to pay interest on one claim while other claims remained unpaid in whole or in part would violate Section 194's requirement that assets be distributed ratably. Pet. App. 39a.

2. The court of appeals held that the district court erred by imposing a constructive trust on any of petitioners' deposits. Pet. App. 1a-21a.

a. The court of appeals first concluded that federal law governed. It acknowledged that Congress has not enacted specific legislation governing the pre-insolvency relationship between a national bank and its depositors, but noted that it has enacted specific legislation governing the distribution of assets of a national bank after the insolvent bank is closed. That legislation requires a ratable distribution of assets among all general creditors entitled to share in the receivership estate—Section 194 provides that "the comptroller shall make a ratable dividend * * * on all such claims as may have been proved to his satisfaction or adjudicated in a court of competent jurisdiction." It also precludes payments by bank officers that prefer some creditors to others—12 U.S.C. 91 provides that "the preference of one creditor to another * * * shall be utterly null and void." Pet. App. 8a-9a.

In light of Congress's directions with respect to the distribution of a failed bank's assets, the court of appeals held that "[a]s of the moment that a national bank is declared insolvent and goes into the hands of a receiver, federal law governs the distribution of the bank's assets." Pet. App. 9a. Thus, the court concluded, "[a]ll state laws inconsistent with the 'system of equal distribution' established by the

National Bank Act are preempted" (*ibid.*, quoting *Jennings* v. *United States Fidelity & Guar. Co.*, 294 U.S. 216, 226 (1935)), since "[i]n no other way could there be unity of administration, and a carrying out of the federal mandate of equality" (Pet. App. 9a, quoting *First Nat'l Bank* v. *Selden*, 120 F. 212, 215 (7th Cir. 1903)). The court further explained (Pet. App. 10a) that the National Bank Act must be read in conjunction with the Federal Deposit Insurance Act, which specifically provides that where the FDIC is acting as the receiver of a federal bank all suits are "deemed to arise under the laws of the United States" (12 U.S.C. 1819 Fourth).

The court of appeals concluded that petitioners could not avoid the application of federal law by claiming that their equitable right to the funds arose prior to insolvency. The court held that "[t]he equitable fiction of trusts relating back to the date that the plaintiffs deposited their funds in PSB * * * does not change the fact that by purchasing a certificate of deposit in PSB, the plaintiffs intended a debtor and creditor relationship," not one of beneficiary and trustee. Pet. App. 11a.

However, the court noted that "[t]he relevant provisions of the National Bank Act admittedly do not provide explicit guidance for the disposition of all claims against the receiver's estate." Pet. App. 12a. The court therefore went on to state that even though it had decided that federal law governs the petitioners' claims, that did not necessarily preclude the imposition of a constructive trust in accordance with Oklahoma law: "In fashioning the federal common law in this area we may look for guidance to the law of the state having the closest connection to the transaction at issue when to do so would not conflict with

the need for uniform rules governing bank liquidations." Pet. App. 13a (quoting *FDIC* v. *Palermo*, 815 F.2d 1329, 1334 (10th Cir. 1987)). But the court determined that the National Bank Act's "unfriendliness to special interests requires a claimant seeking a preference from pro rata distribution of assets to bear a heavy burden of proof." Pet. App. 15a (citing *Hibernia Nat'l Bank* v. *FDIC*, 733 F.2d 1403, 1408 (10th Cir. 1984)). The court held that a "national bank's fraudulent conduct may give rise to a constructive trust only when the plaintiff can show that the bank's fraud caused a particular harm that is not shared by substantially all other depositors, and that granting relief to the plaintiff does not disrupt the orderly administration of the receiver's estate." Pet. App. 15a.

b. With respect to petitioners' claims, the court of appeals determined that the fraudulent statements contained in Penn Square Bank's financial statements were not directed specifically to the two credit unions. Pet. App. 19a. It concluded that "[i]n the absence of a false and fraudulent representation made specifically to the plaintiff, with respect to the financial condition of the [bank], the plaintiff has no equity superior to the rights of other depositors or creditors of the [bank], who made deposits in said [bank] in reliance upon the statements published by said [bank]." Pet. App. 20a (quoting *Beacon Mfg. Co.* v. *Hood*, 204 N.C. 349, 351, 168 S.E. 523, 524 (1933)).

The court rejected petitioners' suggestion that unequal treatment of depositors could be avoided by permitting all depositors similarly situated to the plaintiffs to sue as a class. It determined that Congress had not intended to deluge the FDIC with

claims for preferences on behalf of all the uninsured depositors who could show that they relied upon misleading information that was available to all depositors. Rather, the court determined, "[a]ny remedy for fraudulent representations that affects, or potentially affects, all creditors belongs to the receiver, who asserts such claims for the benefit of all creditors" and distributes the proceeds on a pro rata basis. Pet. App. 21a.

ARGUMENT

The court of appeals correctly held that federal law rather than state law governs petitioners' claims and that petitioners are entitled to no preference under the facts of this case. Since its decision does not conflict with any decision of this Court or another court of appeals, further review is not warranted.

1. a. Although state law generally governs the relationship of a bank with its customers, "[s]tate law governance of the preinsolvency contracts of national banks is limited * * * by the paramount authority of Congress to regulate national banks." Pet. App. 8a.

> National banks are instrumentalities of the federal government, created for a public purpose, and as such necessarily subject to the paramount authority of the United States. It follows that an attempt by a state to define their duties or control the conduct of their affairs is absolutely void, wherever such attempted exercise of authority expressly conflicts with the laws of the United States, and either frustrates the purpose of the national legislation or impairs the efficiency of these agencies of the federal government to discharge the duties for the performance of which they are created. These principles are axiomatic, and are sanctioned by the repeated adjudications of this court.

Davis v. *Elmira Sav. Bank*, 161 U.S. 275, 283 (1896). Relying on these principles, the court of appeals correctly held that, following a determination that a bank is insolvent, federal law preempts state law since Congress has enacted legislation governing the distribution of a failed bank's assets. Pet. App. 9a (citing *American Surety Co.* v. *Bethlehem Nat'l Bank*, 314 U.S. 314, 316-317 (1941), and *First Nat'l Bank* v. *Selden*, 120 F. 212, 215 (7th Cir. 1903)).

Petitioners contend that state law should apply here because, under it, their *pre*-insolvency relationship with Penn Square Bank was that of beneficiary and trustee. But petitioners' intention in depositing their funds in Penn Square Bank was to establish the relationship of debtor and creditor. See *Bank of Marin* v. *England*, 385 U.S. 99, 101 (1966) (absent a showing of specific intent to the contrary, the relationship of a bank to its depositors is that of debtor and creditor founded upon contract). Petitioners seek to change their relationship with Penn Square Bank *post*-closing to one of trustee and beneficiary. Despite the equitable fiction that a constructive trust arises at the time of the fraud, the characterization of the relationship of petitioners and the Bank is a post-insolvency matter governed by federal law.

b. Under federal law, no constructive trust is warranted under the facts of this case. As the court of appeals noted (Pet. App. 8a-9a), Section 194 states that creditors are to receive a "ratable dividend." Thus, as the court of appeals held (Pet. App. 15a), a creditor of an insolvent bank seeking a preference must overcome a heavy presumption to the contrary. Petitioners—who have merely shown that they relied on misleading statements in Penn Square Bank's financial reports—have not carried their burden. They

have established no particular harm to them not shared by other depositors. Indeed, the district court acknowledged that the Bank's "officers and directors intended to defraud all potential investors, depositors and creditors." *Id.* at 33a.

The imposition of a constructive trust under the facts of this case would undermine the ratable distribution rule since, if a depositor could receive full repayment of uninsured funds simply by demonstrating that he based his investment decision on a bank's financial statements and that those statements proved to be misleading, then most creditors of a failed national bank would have claims for full repayment. Many if not most institutions which fail have at some point made material misstatements of their financial condition, and most investors can be said to rely to some degree on the publicly disseminated financial statements of banks in which they invest. As the court of appeals stated, permitting some creditors to receive a preferential recovery by filing lawsuits (and thus depleting the estate's assets) quickly, despite the fact that all creditors similarly situated would have the same claim, would make "the equality promised to them * * * a mere mockery." Pet. App. 21a (quoting *National Bank* v. *Colby*, 88 U.S. (21 Wall.) 609, 614 (1875)).

2. Contrary to petitioners' contentions (Pet. 9, 10, 16), there is no conflict in the circuits on the question presented. Petitioners cite no decision, and we know of none, where a court of appeals approved the imposition of a constructive trust in a case like this one.

In *Reno Nat'l Bank* v. *Seaborn*, 99 F.2d 482 (9th Cir. 1938), a depositor had instructed the Bank to transfer the depositor's funds to another institution

and the Bank promised to do so but did not. The Bank then became insolvent, and the depositor sought to recover in full. The court of appeals concluded that there was no need for federal uniformity with respect to the question at issue (*id.* at 483), but went on to hold under state law that the depositor should not be treated more favorably than other creditors. The decision not to provide a preference in *Reno Nat'l Bank* is not in conflict with the decision not to provide a preference in this case. Moreover, not only is the result in *Reno Nat'l Bank* in accord with that of the decision in this case, the court's decision to consult state law is not necessarily in tension with the reasoning of the court below. As it explained, in applying federal common law, a court "may choose to adopt state law." Pet. App. 11a-12a n.6. Furthermore, the court below suggested that the imposition of a constructive trust might be appropriate where, as in *Reno Nat'l Bank*, a depositor suffered a particular harm not shared by other creditors. See Pet. App. 16a.

That was the case in *Fiman* v. *South Dakota*, 29 F.2d 776 (8th Cir. 1928), cert. denied, 279 U.S. 841 (1929). In *Fiman*, the State's rural credit board had made uninsured deposits in violation of a state law that restricted the amount that it could deposit in any particular institution; thus, its claim was based on a particular law that was not applicable to other depositors. The court of appeals concluded that the State's deposits had "been distinguished and pointed out as money belonging to the state." *Id.* at 783. In this case, in contrast, petitioners' deposits have not been distinguished from those of other creditors, since petitioners, like other depositors, relied to their detriment on Penn Square

Bank's misleading financial statements, which were available to all depositors.

Nor is *FDIC* v. *Braemoor Associates*, 686 F.2d 550 (7th Cir. 1982), cert. denied, 461 U.S. 927 (1983), in conflict with the decision here. In that case the FDIC was acting as the receiver of a state bank rather than a federal bank (see Pet. App. 10a & n.5), and the court decided to apply state law in "the absence of any ready-made federal common law." 686 F.2d at 554. There was an absence of federal law because that case did not involve a depositor seeking to obtain an exception from the National Bank Act's ratable distribution requirement. Rather, the FDIC was attempting to recover money that the president of the failed bank had funneled from the bank to a real estate venture in which he was a partner.

Finally, there is no merit to petitioners' claim that the court's decision conflicts with cases construing federal bankruptcy law. Specifically, petitioners contend that the court of appeals' determinations of what constitutes an asset of a debtor's estate and whether property obtained by fraud may be retained for the benefit of that estate are inconsistent with determinations of the same issues under the Bankruptcy Act. But the court's decision does not permit the receivership estate to retain any funds fraudulently obtained. It merely provides that where all creditors are similarly harmed, the assets of the estate should be ratably distributed among all creditors. That result is in accord with the federal bankruptcy laws requiring ratable distribution of assets among creditors of the same class.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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